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Supreme Court of the United States

OCTOBER TERM, 1970

No. 1000

SCUDDER & GERMAN, a partnership,

Petitioner,

—against—

STANLEY S. PEARLSTEIN,

Respondent.

REPLY OF PETITIONER FOR CERTIORARI TO RESPONDENT'S BRIEF

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Petitioner seeks review by this Court of a decision of the United States Court of Appeals for the Second Circuit, reversing a judgment for Petitioner (the defendant) of the United States District Court for the Southern District of New York. Judge Friendly dissented from the decision. Chief Judge Lumbard and Judges Moore, Friendly and Hays dissented from an order denying a petition for rehearing in banc.

Respondent sues Petitioner, a registered broker-dealer, to recover the losses he sustained on two of his purchases of convertible bonds, registered on the New York Stock Exchange. Both purchases (of "Lionel bonds" and of "AMF bonds") were made against Petitioner's advice,[1]

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[1] See District Court Opinion, Appendix A, p. A2; Court of Appeals Opinion, Appendix B, pp. A23, A24; Dissenting Opinion, Appendix B, p. A48. The appendices cited herein are the appendices to the petition for certiorari.

pursuant to purchase agreements that were valid and proper in all respects.

Respondent defaulted on both purchase agreements, frustrated Petitioner's efforts to obtain payment, and induced Petitioner not to sell him out. The fact that Petitioner did not "cancel or otherwise liquidate" the transactions constituted a violation of Rule 4(c)(2) of Regulation T,[1] limiting the duration of the credit that a broker may let a cash customer have.

The petition for certiorari presents three important questions of federal law.

1. The first question is whether a customer whose default causes a violation of Regulation T by his broker acquires thereby a private right of action against the broker based on the broker's involuntary extension of credit to him. Neither Regulation T nor the Exchange Act, 15 U.S.C. §§78a *et seq.*, provides for any private right of action in such a case. No federal court had created one by implication, in such a case, prior to the decisions below.[2]

Other panels of the Court of Appeals for the Second Circuit had denied recovery where the customer's conduct caused, as here, an involuntary extension of credit in violation of Regulation T or Regulation U.[3] *A. T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967); *Serzysko v. Chase Manhattan Bank*, 409 F.2d 1360 (2d Cir. 1969), affirming 290 F.Supp. 74 (S.D.N.Y. 1968), cert. denied 396 U.S. 904

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[1] 12 C.F.R. Part 220, §220.4(c)(2), Appendix F, p. A53.

[2] A private right of action has been implied where the broker arranged for an unlawful extension of credit to a customer. See petition for certiorari, p. 11.

[3] 12 C.F.R. Part 221. Regulation U covers the credit that may be extended by banks, Regulation T the credit that may be extended or arranged by brokers.

(1970). See also *Moscarelli* v. *Stamm*, 288 F.Supp. 453 (E.D.N.Y. 1968).

Respondent concedes, at page 2 of his brief, that this question of law is one "never specifically decided by any Federal Court until the decision of the Court of Appeals in this case * * *."[5] It is an important question that should be settled by this Court.

The decision of the majority below would enable an experienced speculator,[6] by judicial implication of a private right of action, to acquire through his own default a free ride in the market, taking the profit if the bonds go up in price, and shifting his loss to the broker if the bonds go down. In the opinion of Judge Friendly, dissenting below, that decision "shocks the conscience", "wars with common sense", and could have "far-reaching consequences".[7]

2. Respondent's rights of action, if any, would have arisen in March and April 1961, when the periods prescribed by Rule 4(c)(2) of Regulation T expired. Respondent continued to evade and frustrate Petitioner's efforts to terminate the credit by collection of the amounts due. Petitioner called in counsel. Respondent, a lawyer well aware of Regulation T, consulted with another lawyer, with the Securities and Exchange Commission, with the New York Stock Exchange, and with the National Association of Securities Dealers.

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[5] See also page 21 of Respondent's brief.

[6] Respondent's brief, at p. 34G, refers to "knowledgeable investors like Respondent." Respondent's expertise in convertible bonds is suggested at pp. 8-9 of his brief. The dissenting opinion below describes him accurately as "an experienced speculator." Appendix B, p. A46.

[7] Dissenting Opinion, Appendix B, p. A38.

The upshot was a settlement proposed by Respondent and embodied in papers dated August 9, 1961, pursuant to which (a) the credit was promptly reduced from over $157,000 to under $30,000, and (b) Respondent retained the Lionel bonds (delivered to his bank by Petitioner on April 5) and received the AMF bonds (delivered to his bank by Petitioner on August 21). Further default by Respondent and settlement negotiations initiated by him resulted in another stipulation of settlement dated November 9, 1961.

The second important question of federal law presented herein is whether those settlement agreements are valid, as held by the District Court, and foreclose Respondent from recovery. Appendix A, pp. A8-A14. The majority of the Court of Appeals held, without any citation of authority, that Section 29(a) of the Exchange Act, 15 U.S.C. §78cc(a),[8] renders the stipulation void. Appendix B, pp. A32-A34.

That decision is flatly in conflict with this Court's interpretation of Section 29(a) in *Wilko* v. *Swann*, 346 U.S. 427, 438 (1953), with the decision of the Court of Appeals for the Third Circuit in *Moran* v. *Paine, Webber, Jackson & Curtis*, 389 F.2d 242 (1968), and with the decisions of other courts of appeals.[9] It could raise havoc with normal procedures for the disposition of private controversies under the federal securities laws. See *Cohen* v. *Tenney Corporation*, 318 F. Supp. 280 (S.D.N.Y. 1970).

As hitherto interpreted, Section 29(a) would prevent a waiver of certain rights before a controversy arises, but not settlement of a controversy that has arisen. Where the section does apply, an agreement violating it is not void but rather voidable, at the option of an innocent party

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[8] Appendix E, p. A51.

[9] See petition for certiorari, pp. 20-22.

who has not waived his statutory right to rescind and is not estopped from asserting it."[10]

On this important question of federal law the decision below is in conflict with applicable decisions of this Court and of other courts of appeals.

3. In accordance with the November 1961 stipulation, and following another default by Respondent, judgment was entered by the Supreme Court of the State of New York in favor of Petitioner, for the balance of $22,713 due then on Respondent's purchase of AMF bonds. Respondent moved to set aside the judgment, alleging violations by Petitioner of Section 7 of the Exchange Act and of Regulation T. Respondent's motion was denied, no appeal was taken, and Respondent paid the judgment.

The District Court held that Respondent was barred by *res judicata* from relitigating the issues that were raised and could have been raised in the State court action. The majority below reversed, holding that Respondent's confession of judgment was "invalid", and that neither the State court judgment nor the order refusing to reopen it operates as *res judicata*, so that Respondent is free to litigate in the federal courts the same issues that were raised and that could have been raised in the State court proceedings."[11]

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[10] Respondent's charges of fraud and duress, appearing throughout his brief, were raised below and are refuted in the district court opinion, Appendix A, pp. A13-A14. The finding is that Respondent, intent on retaining the bonds he had purchased, rationally acted of his own volition and voluntarily entered into the settlement agreements of August and November 1961.

[11] Alleged violations of Regulation T create issues that have been and are being determined in New York State court litigation between brokers and customers. Petition for certiorari, p. 23; *Bache & Co.* v. *Williams*, CCH Fed. Sec. Law Dec. ¶92,730 (Sup. Ct. N.Y. Co. 1970).

The decision of the majority below rests upon the dissenting opinion in *Angel* v. *Bullington*, 330 U.S. 183, 204 (1947), and upon a fallacious attempt to distinguish the majority opinion.

Under principles of *res judicata* as hitherto applied by this Court and the courts of the State of New York, a judgment entered upon a settlement, as here, bars the parties from litigating in any other proceeding, State or federal, issues that could have been raised in the State court proceeding.

The purpose of *res judicata* is to bring litigation to an end, and to promote certainty in legal relations. The question of *res judicata* raised by the decision below is an important question of federal law, and the decision is in conflict with applicable decisions of this Court.

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Respondent's brief suggests at page 47 that the decision of the majority below "is merely interlocutory," not ripe for review. On the contrary, the decision below is a final ruling on the merits that leaves open only the proper measure and amount of damages.

Pursuant to 28 U.S.C. §1254(1), this Court has jurisdiction to review any decision of a court of appeals, whether or not final. *United States* v. *General Motors Corp.*, 323 U.S. 373, 377 (1944); *Land* v. *Dollar*, 330 U.S. 731, 734, n. 2 (1946); *Beacon Theatres, Inc.* v. *Westover*, 359 U.S. 500 (1959). Here, after nine years of litigation, we have a final determination of the important questions of federal law fundamental to the further conduct of the case if the decision below is affirmed, and terminating the case if the decision below is reversed.

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In this reply we refrain from answering the plethora of misstatements, charges, and comments set forth in Respondent's brief. They have little to do with the important issues of federal law presented here for review. We respectfully submit that the petition for a writ of certiorari should be granted.

Dated: New York, N. Y.
March 4, 1971.

Respectfully submitted,

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